TESTIMONY OF
COMMISSIONER WILLIAM L. MASSEY
FEDERAL ENERGY REGULATORY COMMISSION
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

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Mr. Chairman and Members of the Committee on Energy and Natural Resources:

Thank you for the opportunity to testify on the subject of electric restructuring. The Commission is committed to facilitating large and vibrant bulk power markets, yet there are anachronistic jurisdictional and other obstacles to achieving this important goal. I respectfully suggest that the Congressional focus should be on eliminating these obstacles and ensuring reliability. I am concerned that, otherwise, the transition to competitive markets will be prolonged, dramatic price volatility will continue, reliability may suffer, and consumers will be denied truly competitive supply options.

Today, I will focus mostly on what I regard to be an area where reform is most critical to a successful transition to competition: access to, and efficient management of, the transmission grid. Electric power markets are inherently interstate in nature. The laws of physics, and hence power markets, do not respect state boundaries. In order to thrive, such markets must have an open, non-discriminatory, well managed, and efficiently priced interstate transmission network that links buyers and sellers of power. The existing patchwork of inconsistent and outdated jurisdictional rules for this essential interstate delivery system, coupled with splintered network management, create obstacles

and uncertainties that undercut the market. If buyers and sellers lack confidence that electric power will be delivered reliably and on reasonable terms and conditions, they will not transact business.

The seminal applicable laws, the Federal Power Act and the Public Utility Holding Company Act, were enacted in 1935, during an era of old fashioned monopolies and cost-of-service regulation. Their purpose was to ensure that monopolies were appropriately regulated; but now, sixty-five years later, our goal is markets. Changes in the law are necessary.

Although I will be commenting on several pending bills, I endorse the Administration's bill (S. 1047) because it provides an excellent framework for resolving virtually all of the concerns I will raise. The Bingaman bill (S. 1273) also responds well to a number of my concerns and thus I commend that bill to the Committee as well.

One Set of Rules for Transmission

I am convinced that bringing all interstate transmission under one set of open access rules would facilitate vibrant power markets. Hence, I heartily endorse the provisions of pending legislation (S. 1047, S. 1273, S. 2098, S. 516, S. 1284) that would subject the transmission facilities of municipal electric agencies, rural cooperatives, the Tennessee Valley Authority, and the Power Marketing Administrations to the Commission's open access rules. This would clearly be a pro-market change in the law.

Moreover, the majority of transmission -- that is, the transmission that underlies bundled retail sales -- is arguably subject to state control under existing law. This has a balkanizing effect on what is essentially an interstate delivery system. State rules may discriminate against interstate transactions. By way of analogy, imagine that you are driving around the Washington, D.C. beltway. As you cross into Virginia, a flashing sign warns, "Congestion ahead! All vehicles not licensed in Virginia exit immediately!" This kind of discrimination against interstate commerce would be absolutely intolerable, and Congress would no doubt remedy it.

Yet, precisely this kind of discrimination on the transmission grid has been sanctioned by the Eighth Circuit Court of Appeals. In a case involving Northern States Power, the court said that when congestion requires a curtailment, the utility can follow a state rule requiring it to discriminate against interstate wholesale transactions and favor its own in-state retail customers. In what is essentially an interstate power market, this is intolerable. After all, every electron delivered at wholesale is ultimately consumed at retail. Hence, the discriminatory curtailment of a wholesale transaction on the interstate transmission grid will often discriminate against out of state retail customers.

The solution is to subject all transmission, whether it underlies an unbundled wholesale, unbundled retail, or bundled retail transaction, to one set of fair and non-discriminatory interstate rules administered by the Commission. This will give market participants confidence in the integrity and fairness of the interstate delivery system, and will facilitate robust trade. I recommend this change in the law to the Committee.

Thus, I do not support the provisions of pending legislation (S. 1047, S. 1273, S. 2098, S. 516) that would divide the interstate transmission grid between Federal and state jurisdiction. I respectfully suggest that this will place legal obstacles in the way of developing seamless and robust regional power markets. All transmission should be subject to one set of rules, while local distribution wires are governed by state regulations.

RTO Formation

I applaud the several pending bills (S. 1047, S. 1273 and S. 2098) that recognize the importance of forming regional transmission organizations (RTOs). Organizing the interstate grid among roughly six to twelve large RTOs that are operated independently of merchant interests will take a real bite out of vertical market power (i.e., self dealing), promote large regional power markets with efficient and non-pancaked transmission pricing, attract the entry of new generators, and enhance reliability. These virtues are explicitly recognized in the Commission's Order No. 2000.

Grid reliability is one of the unsung benefits of the RTO institution. Existing grid management is scattered among more than one hundred operators. Consolidating grid operations through RTOs (in the form of ISOs, transcos or hybrid entities) will eliminate seams and facilitate institutions that are more congruent with reliability management regions and evolving markets. A large RTO can manage congestion and plan for loop flow efficiently. An RTO can also facilitate regional consensus among market

participants, transmission owners and state siting authorities about the need for new transmission siting and construction. A large RTO also provides the appropriate scope and forum for transmission pricing reform. As such, an RTO can, by adopting performance based rates, provide the incentives for needed new transmission facilities. These features of the RTO can provide a reliable platform for emerging markets.

The full benefits of RTOs to the marketplace will not be realized, however, if they do not form in a timely manner, if they are not truly independent of merchant interests, or if they are not shaped to capture market efficiencies and reliability benefits. I strongly support the provisions of S. 1047 and S. 1273 clarifying existing law to authorize the Commission to require the formation of RTOs and to shape their configuration. The Commission also needs flexibility in its RTO policy. Standards for efficient and reliable RTOs may need to evolve over time along with the nature of electricity markets. Thus, I would not recommend that Congress legislate the detailed standards for RTOs set out in S. 2098.

Reliability

Vibrant markets must be based upon a reliable trading platform with mandatory reliability rules. Yet, under existing law there are no legally enforceable reliability standards. The North American Electric Reliability Council (NERC) does an excellent

job preserving reliability, but compliance with its rules is voluntary. A voluntary system, however, is likely to break down in a competitive electricity industry.

I strongly recommend the enactment of provisions such as those in S. 1047, S. 516 and S. 2098 that would lead to the promulgation of mandatory reliability standards. A private standards organization (perhaps a restructured NERC) with an independent board of directors would promulgate mandatory standards applicable to all market participants. These rules would be reviewed by the Commission to ensure that they are not unduly discriminatory. The mandatory rules would then be applied by RTOs, the entities that will be responsible for maintaining short-term reliability in the marketplace.

Mandatory reliability rules are critical to evolving competitive markets, and I urge Congress to enact legislation to accomplish this objective.

Transmission Expansion

The transmission grid is the critical superhighway for electricity commerce. But it is becoming congested due to the increased demand of a strong economy and to new uses for which it was not designed. Congestion on the transmission grid can be relieved by the redispatch of existing generation, demand reduction measures, curtailment, or bringing new generation on line. The capacity of the transmission wires can be increased by new FACTS technologies that allow wires to be loaded more precisely up to their thermal limits.

Despite these low environmental impact alternatives, however, there are circumstances where the most appropriate option is siting and constructing new transmission wires. New transmission, however, has not kept pace with changes in the marketplace. As I discussed earlier, the Commission believes that several aspects of RTOs will facilitate new transmission facilities. For example, in Order No. 2000, the Commission made clear that it would be responsive to innovative pricing proposals that would facilitate the construction of necessary transmission.

Under current law, however, the Commission does not have the authority to get the job done alone. The Commission has no authority to site electric transmission facilities that are necessary for interstate commerce. Existing law leaves siting to state authorities. This contrasts sharply with section 7 of the Natural Gas Act, which authorizes the Commission to site and grant eminent domain for the construction of interstate pipeline facilities. Exercising that authority, the Commission balances local concerns with the need for new pipeline capacity to support evolving markets.

The provisions of pending legislation that transfer siting authority to the Commission (S. 2098, S. 1273) would make it more likely that transmission facilities necessary to reliably support emerging regional interstate markets would be sited and constructed. I support those provisions.

Mergers and Market Power

As we strive to move toward competitive markets and light-handed regulation, the Commission's ability to remedy market power is increasingly important. Market power is likely to exist in the electric industry for a while. It is unreasonable to expect an industry that has operated under a heavily regulated monopoly structure for 100 years suddenly to shed all pockets of market power. An agency such as FERC with a broad interstate view must have adequate authority to ensure that market power does not squelch the very competition we are attempting to facilitate.

The Commission's authority over mergers is important. We are seeing unprecedented industry consolidation now. While mergers can produce efficiencies, they can also increase both horizontal and vertical market power. The Commission is particularly well suited to evaluate proposed mergers involving electric utilities. The Commission's detailed experience with electricity markets and its unique technical expertise can provide critical insights into a merger's competitive effects. In addition, the Commission's duty to protect the public interest is broader than the focus of the antitrust agencies and thus allows us to better protect consumers from other possible effects of a merger, such as unreasonable costs. As the architect of Order No. 888 and the RTO Rule, Order No. 2000, the Commission must retain the authority to condition a merger to ensure consistency with broader policy goals. And unlike the antitrust agencies, the Commission's merger procedures allow public participation in the restructuring of this vital national industry.

For these reasons, I would not support any weakening of the Commission's merger authority, and I am pleased that the legislation pending before the Senate does not do so. I especially welcome those provisions of the Administration's bill (S.1047) that give the Commission authority over holding company mergers and mergers involving generation-only firms. This new authority may prove critical in a competitive era.

While mitigating the market power still present in electricity markets is of critical importance, the Commission has only indirect conditioning authority to do so. This is inadequate. Markets cannot work where incumbents can dominate the market and withhold capacity or favor affiliates. Markets must be nourished. Barriers to entry must be removed. Market dominance must be mitigated for markets to flourish. The Commission should have the direct authority to mitigate market power and thereby facilitate vibrant markets.

I therefore strongly support the provision of the Administration's bill (S. 1047) that gives the Commission authority to remedy market power in wholesale markets, and to also do so in retail markets if asked by a state commission that lacks adequate authority. I do not support that provision of the Thomas bill (S. 516) that would deregulate all new contracts for wholesale sales. The Commission has for some time allowed market-based pricing for wholesale sales of electricity where the seller lacks market power. Pockets of market power are still likely. Thus, we should continue to be able to review whether sellers have market power before allowing market-based pricing.

Miscellaneous Provisions

I would like to mention briefly a few other recommendations to the Committee.

First, I would recommend the repeal of PUHCA, with appropriate provisions to ensure that Federal and state regulators have access to necessary books and records. Several pending bills would accomplish this purpose.

Second, I would recommend the prospective repeal of the mandatory purchase requirement in PURPA, with appropriate protections for existing contracts. I would also recommend all reasonable legislative efforts to promote renewable energy resources. A reasonable portfolio standard would be appropriate.

Conclusion

In closing, let me note that I have reviewed Chairman Hoecker's much more detailed testimony about several pieces of pending legislation and I generally endorse the thrust of his remarks.

I stand ready to assist the Committee in any way as the legislative process evolves, and I thank the Committee for this opportunity testify.